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**The Non-designation of Derivatives as Hedges for Accounting Purposes**

**EXECUTIVE SUMMARY**

The FASB recently issued Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities: An Amendment of FASB Statement No. 133*. The proposed standard simplifies the accounting for hedging activities and generally increases the appeal of hedge accounting. In this report we survey firms' reporting practices and examine hedges and hedge accounting generally and seek to determine why firms may decide not to designate derivatives as hedges for accounting purposes. In reviewing the reports of a large sample of firms, we find the following four explicit reasons why companies may decide not to designate derivatives as accounting hedges: (1) the substantial cost of documentation and ongoing monitoring of designated hedges; (2) the availability of natural hedges that can be highly effective; (3) a new accounting standard that broadens the applicability of natural or economic hedges; and (4) qualifying hedges are not available or are too costly or documentation is untimely, inadequate, or unavailable. In addition, a fifth reason, not offered as such by the surveyed firms, is the increased risk of restatement that accompanies hedge accounting. The proposed standard combined with the recently-released SFAS 159, *The Fair Value Option for Financial Assets and Liabilities*, offer companies a welcome relief to the onerous accounting and reporting requirements of SFAS 133.

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**Georgia Tech Financial Analysis Lab**

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A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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## The Non-designation of Derivatives as Hedges for Accounting Purposes

By Eugene E. Comiskey and Charles W. Mulford

### Introduction

Recently, the Financial Accounting Standards Board (FASB) issued Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities: An Amendment of FASB Statement No. 133*.<sup>1</sup> The purpose of the proposed standard is to amend accounting for hedging activities in FASB Statement No. 133, (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*.<sup>2</sup> Among its provisions, the proposal seeks to simplify the accounting for hedging activities. Toward achieving this objective, the proposed standard would a) lessen the effectiveness threshold necessary for applying hedge accounting from *highly* effective to *reasonably* effective at offsetting changes in fair value or variability in cash flows and b) require an effectiveness evaluation at inception of the hedging relationship, though after inception, an effectiveness evaluation would be required only if circumstances suggest that the hedging relationship may no longer be reasonably effective.

A key purpose of hedge accounting is to reduce earnings volatility by recording in earnings in the same time period a gain or loss on a hedged item and the loss or gain on the related hedge. With hedge accounting, whether a gain or loss on the hedged item is recognized currently or deferred in accumulated other comprehensive income, an offsetting loss or gain on the hedge is recognized in a similar way. For example, with hedge accounting, a loss arising from a forward contract to sell Yen would be recognized in earnings along with a gain on an underlying Yen-denominated receivable. Similarly, a gain on an interest rate swap used to hedge variable rate debt and effectively convert it to a fixed rate obligation would be deferred in accumulated other comprehensive income as no loss would be recognized currently on the underlying debt. The matching of gains and losses in this way is a desirable outcome, but one that is not achieved if the criteria of SFAS 133 are not met. Under SFAS 133, however, such accounting treatment requires that the hedge is highly effective in offsetting specifically identified risks and that the effectiveness of the hedge is monitored regularly after inception. Such criteria are often difficult to meet, resulting in the non-application of hedge accounting and a mismatch of gains and losses on hedged items and their related hedges and the potential for increased earnings volatility.

By simplifying the requirements, the proposed amendment of SFAS 133 seeks to broaden the appeal of hedge accounting. The implication is that at present, due to the complexities of SFAS 133, firms who might otherwise apply hedge accounting for derivatives transactions may not be doing so. It would seem, however, that there may be other reasons apart from the complexities of SFAS 133 that may lead firms to decide not to apply hedge accounting.

The purpose of this study is to examine hedges and hedge accounting generally and to explore decisions made by firms not to designate derivatives as accounting hedges. The study is motivated in part by the observance of numerous cases where firms employ derivatives that work

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<sup>1</sup> Financial Accounting Standards Board, Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities: An Amendment of FASB Statement No. 133*, (Norwalk CT: Financial Accounting Standards Board, June 2008).

<sup>2</sup> Financial Accounting Standards Board, SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (Norwalk, CT: Financial Accounting Standards Board, 1998).

well as *economic* hedges, but where the derivatives are not designated for hedge accounting. The end result may be increased earnings volatility. There is a cost associated with increased earnings volatility in the form of a potential reduction in firm value.<sup>3</sup> However, there are also costs associated with the documentation and monitoring required for qualifying and sustaining a derivative for hedge accounting. What we seek to determine is whether the complexities of SFAS 133, and the related costs, appear to be prominent in the firms' decisions not to employ hedge accounting.

The outline of this report is as follows: in section (1) we provide a brief review of the range of hedge designations that can be applied to derivatives and the basic features of hedge accounting applicable to these designations; section (2) outlines important nomenclature associated with hedges that are achieved with or without the use of derivatives and/or hedge accounting; in section (3) examples of firms that employ derivatives for hedging purposes but do not designate them for hedge accounting are provided; section (4) identifies apparent reasons for the non-designation of derivatives; section (5) provides illustrations of the influence that the non-designation of derivatives can have on earnings, and section (6) summarizes the study's results and provides observations on future developments for hedge accounting.

## 1. Derivative Designations and Associated Accounting

A derivative not designated for hedge accounting is carried on the statement of financial position at its fair value. The gains and losses associated with the changes in the fair value of these derivatives are included in the income statement as they occur. However, derivatives that meet the requirements of SFAS No. 133 may be designated as accounting hedges. The designations of derivatives for accounting purposes are either as fair-value hedges or cash-flow hedges.

### Fair-value hedges

Derivatives used to hedge the fair value of recognized assets and liabilities or firm commitments are referred to as fair-value hedges.<sup>4</sup> The effectiveness of the hedge is based upon the extent to which the gain or loss on the derivative offsets the loss or gain on the hedged position. With a perfectly effective hedge, the gains and losses on the derivative and the hedged position exactly offset each other and are recognized in the same reporting period. Such a result shields earnings from the volatility that would otherwise result from changes in the *underlying* of the derivative, e.g., a foreign currency rate, an interest rate, the price of grain, etc. Any difference between the gain or loss on the derivative and the loss or gain on the hedged item is referred to as hedge ineffectiveness and is recognized currently in earnings.

The accounting for a perfect fair-value hedge of an asset with a derivative is outlined below. Assume that the value of an equity security held for trading purposes is hedged with the purchase of a put option. The gain on the hedge and the loss on the investment are each assumed to be \$1

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<sup>3</sup> Earnings volatility is documented to have a negative effect on firm value. An example of this research is, Rountree, B., J. Weston, and G. Allayannis, "Do Investors Value Smooth Performance?" Forthcoming, *Journal of Financial Economics*, Hunt, A., S. Moyer and T. Schevlin, "Earnings Volatility, Earnings Management, and Equity Value," Working Paper, University of Washington, January 1997 and Barnes, R., "Earnings Volatility and Market Valuation: An Empirical Investigation," Working Paper No. ACCT19, London Business School. Available at SSRN: <http://ssrn.com/abstract=335380>.

<sup>4</sup> SFAS No. 133, paras. 20 to 27.

million. If there were some ineffectiveness with the hedge, this difference would be included in the income statement.

- (1) Recording the decrease in the fair value of the hedged asset
  - a. Loss of \$1 million from the decline in the value of the trading security
  - b. Decrease in the fair value of the trading security by \$1 million
- (2) Recording the increase in the fair value of the derivative
  - a. Increase of \$1 million in the fair value of the put option
  - b. Gain of \$1 million from the increase in the fair value of the put option

Note that the loss on the hedged asset in (1a) is perfectly offset by the gain on the derivative in (2b).

### Cash-flow hedges

Cash-flow hedges result when derivatives are employed to hedge “. . . the exposure to expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability . . . or a forecasted transaction . . .”<sup>5</sup> Unlike the fair-value hedges, where offsetting gains and losses are recognized on a contemporaneous basis, this ongoing symmetry (within the income statement) of recognized gains and losses is not present with a cash-flow hedge. As a result, the effective portion of gains and losses on the derivatives are initially recorded in accumulated other comprehensive income (i.e., shareholders’ equity). These accumulated gains and losses of the derivative are subsequently reclassified into the income statement “. . . in the same period or periods during which the hedged forecasted item affects earnings.”<sup>6</sup>

The accounting for the perfect hedge of a forecasted purchase of jet fuel by an airline is outlined below. The use of heating oil to hedge jet-fuel prices is common because of the absence of an organized futures market for jet fuel. For example, Southwest Airlines notes that, “However, the Company has found that financial derivatives in other commodities, such as crude oil, and refined products such as a heating oil and unleaded gasoline, can be useful in decreasing its exposure to jet fuel price increases.”<sup>7</sup> With an increase in the price of heating oil, the derivative, assume a call option, increases in value during period one by \$5 million. As a cash-flow hedge, this gain is reported as follows:

- (1) Accounting for the increase in the fair value of the derivative
  - a. Increase of \$5 million in the fair value of the call option
  - b. Gain of \$5 million on the derivative included in accumulated other comprehensive income

The forecasted purchase is not on the balance sheet to be revalued. As a result, there is only the gain on the derivative to be recorded. Without an offsetting loss recognized in the same period,

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<sup>5</sup> SFAS No. 133, para. 28.

<sup>6</sup> SFAS No. 133, para. 31.

<sup>7</sup> Southwest Airline, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 31.



the gain on the derivative is held in accumulated other comprehensive income until the jet fuel has been purchased, used, and included in the income statement. We assume that this takes place in period two and that no additional change in the value of the derivative has occurred.

(2) Accounting for the reclassification of the accumulated other comprehensive gain

- a. Decrease of \$5 million in accumulated other comprehensive income
- b. Reduction of \$5 million in jet fuel expense

The above treatment reclassifies the gain on the heating oil derivative (1b) into the income statement as a reduction in the cost of jet fuel (2b). The gain reduces the fuel cost that increased because of an increase in the market price of the fuel. Without this hedge accounting, the derivative gain would have been recognized in period one and the increase in fuel costs in period two. This treatment is unnecessary in the case of the fair-value hedge since both the gains and offsetting losses associated with the derivative and the hedged item are recognized in the same period.

In contrast to the above perfect hedge, it is notable that Southwest Airlines was required to de-designate some of its fuel hedges because of a decline in their effectiveness, especially unleaded gasoline derivatives. While these derivatives lost their hedge-accounting status, Southwest continued to hold these instruments because, “It believes they continue to represent good *economic hedges* in its goal to minimize jet fuel costs.”<sup>8</sup>

### Foreign currency hedges

The accounting for foreign-currency hedges is treated separately in SFAS No. 133.<sup>9</sup> When the hedged item is in a foreign currency, the hedge may be designated as, (1) a fair-value hedge in the case of unrecognized firm commitments and recognized assets and liabilities; (2) a cash-flow hedge in the case of forecasted transactions, including cash flows associated with recognized assets and liabilities, and unrecognized firm commitments; and (3) a net investment hedge in the case of the net investment in a foreign operation.<sup>10</sup> The accounting for foreign currency fair-value and cash-flow hedges are similar to the treatment afforded other derivatives and additional details are not provided here.

### The key objective behind hedge accounting

The key objective of the application of hedge accounting is well stated in the following sentence: “Hedge accounting enables the recording of gains, losses, revenues and expenses from derivative instruments in the same period as for those related to the hedged item.”<sup>11</sup> The goal of hedge accounting is matching, whereby gains and losses on a hedge offset losses and gains on the hedged item, together with the carrying of all derivatives on the balance sheet at fair value.

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<sup>8</sup> Southwest Airlines, p. 49.

<sup>9</sup> SFAS No. 133, paragraphs 36 to 42. SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*—an amendment of FASB No. 133, allows “. . . a recognized foreign currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge”, para. 25.

<sup>10</sup> SFAS No. 133, para. 36.

<sup>11</sup> This citation is from page 56 of the 2007 annual report of Wallbridge Mining Company, Ltd. Wallbridge in turn cites Section 3865 of the CICA Handbook (Canadian Institute of Chartered Accountants). The hedge accounting goals under Canadian GAAP is comparable to United States GAAP.



## 2. Hedge-accounting Nomenclature

A review of disclosures associated with derivatives and hedges introduces a number of terms that are sometimes either not well understood or that appear to be interpreted in more than one way. Some of the more important of these terms are discussed and illustrated in this section.

### Economic hedges

It is common to encounter the use of the expression, *economic hedge*, when firms discuss the use of either a derivative or a non-derivative in a hedge application that does not qualify for hedge accounting or is simply not designated as an accounting hedge. The derivatives of Repsol YPF, S.A. below may qualify for hedge accounting, but are not always designated as an accounting hedge. In using the economic hedge expression, the firm indicates that the derivatives shield the firm from the volatility in the prices of the targeted commodities. That is, the gains and losses produced by the price volatility are offset by the losses and gains of the commodities-related derivatives. However, absent the use of hedge accounting, these gains and losses may not be recognized in the income statement within the same periods.

#### Repsol YPF, S.A.

“Our results of operations are exposed to volatility in the prices of crude oil, natural gas and oil products. The Repsol YPF Group occasionally contracts financial derivatives with the aim of decreasing exposure to these commodity price risks. These derivatives offer an *economic hedge* of the results, even though these are not always designated as hedging instruments for accounting purposes” (12/31/07, Form 20-F, p. 161).

The case below of Navistar Financial Corp. also involves the use of a derivative instrument, an interest rate swap, which creates an economic hedge without the swap qualifying for hedge accounting. The unfavorable adjustment referenced by Navistar reflects the absence of contemporaneous offsetting gains and losses in the case of this undesignated hedge.

#### Navistar Financial Corp.

“[t]he required mark to market of the swaps associated with the secured borrowings resulted in unfavorable non-cash adjustments of approximately \$38.0 million in our consolidated statements of income through the first half of fiscal 2008. These swaps do not qualify for hedge accounting under SFAS No. 133, thus the non-cash adjustment is a period cost. The swaps do provide us, however, with an *economic hedge* of the expected future interest cash flows associated with the secured borrowings” (10/31/07, Form 10-K, p. 11).

### Fair value accounting

In its use in practice, *fair-value accounting* is similar to the *economic-hedge* expression. That is, fair-value accounting is typically associated with the use of derivatives that do not qualify for hedge accounting or are simply not designated as accounting hedges. The expression, mark-to-market accounting, is also used interchangeably with fair-value accounting. The following examples from Husker AG, LLC, Red Trail Energy, LLC and Sara Lee Corp. highlight the economic hedge and fair-value/mark-to-market accounting connection:

Husker AG, LLC

“Although Husker Ag believes that its hedge positions accomplish an *economic hedge* against future purchases, they do not match the gain or loss on the Company’s hedge positions to the specific commodity purchase or sale being hedged. Husker Ag is using *fair value accounting* for its hedge positions, which means as the current market price of the Company’s hedge positions changes, the gains and losses are immediately recognized on the Company’s income statement as gain or loss on option and futures contracts” (12/31/07, Form 10-K, p. 40).

Red Trail Energy, LLC

“Although we believe our hedge positions will accomplish an *economic hedge* against our future purchases, they likely will not qualify for hedge accounting, which would match the gain or loss on our hedge positions to the specific commodity purchase being hedged. We intend to use *fair value accounting* for our hedge positions, which means as the current market price of our hedge positions changes, the gains and losses are immediately recognized in our cost of sales” (12/31/07, Form 10-K, p. 27).

Sara Lee Corp.

“The corporation uses either hedge accounting or mark-to-market accounting for its derivative instruments. In 2007, the corporation adopted a policy to use *mark-to-market* accounting for foreign currency derivatives due to the high cost of using hedge accounting and maintaining hedge documentation” (6/30/07, annual report to shareholders, p. 56).

Sara Lee’s mark-to-market accounting is basically interchangeable with the fair-value accounting used by Husker AG and Red Trail Energy. The derivatives used by both Husker AG and Red Trail produce economic hedges. The only hedge-related accounting that is required is the periodic adjustment of the derivatives to fair value, i.e. fair-value accounting.

**Freestanding derivatives**

There is some variation in the use of the label, *freestanding derivatives*, as is common with much financial terminology. Santander Bancorp, following the header, “Derivative instruments not designated as hedging instruments,” states that: “Any derivative not associated to hedging activity is booked as a freestanding derivative.”<sup>12</sup> Freestanding in this case would reference the lack of a linkage with, for example, other assets or liabilities as is the case of a hedging relationship. In other cases, a freestanding derivative is used in contrast to an embedded derivative. An embedded derivative is a derivative that is part of a host contract--a hybrid instrument.<sup>13</sup> Given the focus of this study, the more common use of the freestanding derivatives label is in line with the above Santander application. Two other examples of the use of freestanding derivatives are:

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<sup>12</sup> Santander Bancorp, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 70.

<sup>13</sup> See SFAS No. 155, *Accounting for Certain Financial Hybrid Instruments, an amendment of FASB Statements No. 133 and 140*, (Norwalk, CT: Financial Accounting Standards Board, 2006).

Federal Home Loan Bank of Seattle

“We may also purchase interest-rate exchange agreements, such as swaptions, to manage the prepayment risk embedded in the mortgage loans. Although these derivatives are valid economic hedges against the prepayment risk of the mortgage loans, they are not specifically linked to individual mortgage loans, and we account for these instruments as *freestanding derivatives* pursuant to SFAS 133” (12/31/07, Form 10-K, p. 76).

Hanover Capital Mortgage Holdings, Inc.

“Although there is an offsetting correlation to the change in the value of the one-month LIBOR caps to the change in the value of the Subordinate MBS (mortgage backed securities) as interest rates increase, it is not 100 percent effective. Additionally, because our interest rate caps are treated as *freestanding derivatives*, the changes in the value of the interest rate caps flow through our income statement while changes in the value of the asset may be reflected as other comprehensive income, to the extent such Subordinate MBS have been classified as available for sale securities and any declines in value are not considered other-than temporary” (12/31/07, Form 10-K, p. 7).

The use of the expression, freestanding derivatives, by the Federal Home Loan Bank of Seattle is comparable in its meaning to the earlier discussion of *economic hedges* and *fair-value accounting*. That is, these derivatives are not designated as *accounting hedges*. One can reasonably conclude that in disclosures related to hedges and derivatives the terms economic hedge, fair-value accounting, and freestanding derivatives each refer to derivatives that have not been designated for hedge accounting.

**Natural hedges**

It is typical for firms to first identify the presence of any natural hedges before the use of derivative instruments is considered: “The Company will only secure a derivative if there is an identifiable underlying exposure that is not otherwise covered by a natural hedge.”<sup>14</sup> A narrow definition of natural hedges would include symmetrically opposite positions, e.g., both accounts receivable and accounts payable in the Euro, that are simply the product of the nature and operation of the business. The BioSphere, Reading, and Realogy examples provided below each illustrate this concept of a natural hedge. Moreover, they are the most common of the natural hedges encountered in this study.

The Dell and Simon Property hedges, also below, are somewhat less natural, though equally effective. Dell uses a currency derivative to achieve its natural hedges and Simon Property appears to design its financings so as to achieve its natural hedges. These somewhat less natural methods may result in costs that are not incurred with the more natural of the natural hedges. There is little economic difference, with the exception of documentation and monitoring costs, between Dell’s natural hedge and the financial effects that would result from these hedges being qualified as fair-value hedges. Moreover, there should be little difference between both the amounts and timing of the gains and losses associated with Dell’s natural hedges versus the outcomes if the derivatives had been designated for hedge accounting.

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<sup>14</sup> Brush Engineered Materials, Inc., Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 63.

BioSphere Medical, Inc.

“We have not engaged in formal currency hedging activities to date, but do have a *limited natural hedge* in that both our revenue and expenses in France are primarily denominated in the euro” (12/31/07, Form 10-K, p. 56).

Dell Inc.

“Dell uses forward contracts to hedge monetary assets and liabilities, primarily receivables and payables, denominated in a foreign currency. The change in the fair value of these instruments represents a *natural hedge* as their gains and losses offset the changes in the underlying fair value of the monetary assets and liabilities due to movements in currency exchange rates. . . These contracts are not designated as hedges under SFAS 133. . .” (2/1/08, Form 10-K, p. 62)

Reading International, Inc.

“While we report our earnings and assets in US dollars, substantial portions of our revenues and of our obligations are denominated in either Australian or New Zealand dollars. The value of these currencies can vary significantly compared to the US dollar and compared to each other. We typically have not hedged against these currency fluctuations, but rather have relied upon the *natural hedges* that exist as a result of the fact that our film costs are typically fixed as a percentage of box office, and our local operating costs and obligations are likewise typically denominated in local currencies” (12/31/07, Form 10-K, p. 20).

Realogy Corp.

“In the normal course of business, the Company borrows funds under its securitization facilities and utilizes such funds to generate assets on which it generally earns interest income. The Company does not believe it is exposed to significant interest rate risk in connection with these activities as the rate it incurs on such borrowings and the rate it earns on such assets are based on similar variable indices, thereby providing a *natural hedge*” (12/31/07, Form 10-K, p. F-51).

Simon Property Group, L.P.

“We have also funded our European investments with Euro-denominated borrowings that act as a *natural hedge* against local currency fluctuations. This has also been the case with our Premium Outlet joint ventures in Japan and Mexico where we use Yen and Peso denominated financing, respectively” (12/31/07, Form 10-K, p. 67).

### 3. Examples of Non-designated Derivatives

Exhibit 1 provides examples of financial disclosures that report the non-designation of derivatives for hedge accounting. Some comments, as well as portions of the text surrounding these disclosures, are provided to help understand the motivation for and impact of non-designation. However, a more careful consideration of the motivation for non-designation is addressed in section 4.

Each of the firms included in Exhibit 1 has one or more undesignated derivatives. The information included for each firm is: (1) the nature of the hedged exposure, (2) the derivative instruments utilized but not designated for hedge accounting and (3) the hedge-accounting character of the derivatives *if* they were qualified and designated for hedge accounting. We note

at the outset that most firms that do not designate some or all of their derivatives for hedge accounting seldom provide an explicit explanation for the non-designation. However, a careful review of this representative set of disclosures does provide some insight into the designation decision. Exhibit 2 in section 4 addresses more directly firms' motivation for non-designation.

### Sample descriptive data

The risk exposures by frequency for the 25 firms included in Exhibit 1 were 43 percent foreign currencies, 36 percent interest rates, and 21 percent commodities. In addition, the derivative instruments used, but undesignated for hedge accounting, were 39 percent forward contracts, 29 percent swaps (almost all interest-rate swaps), 20 percent options, and 12 percent futures. The relative use of the various derivatives is comparable to surveys that have been done in the past.<sup>15</sup> A more recent Wharton study reports the following hedge targets for firms using derivatives: 83% hedge the risk of foreign currencies, 76% hedge interest-related risk, 56% hedge commodity risk and 36% use derivatives based upon equity, or stock, markets.<sup>16</sup> Again, these data are very comparable to the hedge targets of the sample of firms in Exhibit 1. Finally, the hedge-types, if the non-designated derivatives had been designated for hedge accounting, would have been 18 fair-value hedges and 13 cash flow hedges.<sup>17</sup>

With this descriptive data presented, we now review the disclosures provided by the sample of 25 firms of firms with derivatives that were not designated as hedges for accounting purposes.

Note that in Exhibit 1, *Hedged exposure* represents the potential hedge targets of the undesignated derivatives, *Derivatives* represent the instruments used by the firm in its undesignated hedging activities, and *Accounting Hedges* are the hedge positions that would have been applied if the derivatives had been designated as accounting hedges.

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<sup>15</sup> G. Bodnar, G. Hayt, and R. Marston, "The Wharton Survey of Derivatives Usage by U.S. Non-Financial Firms," *Financial Management*, (Winter 1996), pp. 113-133.

<sup>16</sup> A summary of the cited study, "How Companies Use Derivatives," is available at: [knowledge.wharton.upenn.edu](http://knowledge.wharton.upenn.edu) as of June 4, 2008. The survey is the joint effort of Wharton and CIBC World Markets, an arm of the Canadian Imperial Bank of Commerce.

<sup>17</sup> The numbers do not total the sample size of 25 because some firms had more than one undesignated derivative and both hedge types, fair value and cash flow, would have been designated if hedge accounting were elected.

**Exhibit 1: Firms with Non-designated Derivatives**

Company	Hedged Exposure	Derivative(s)	Accounting Hedge(s)
1. <u>Applied Materials, Inc.</u>	FX assets and liabilities	FX forward contracts	Fair value

Comments and quotes: “Forward exchange contracts are generally used to hedge certain foreign currency denominated assets or liabilities. These derivatives are not designated for hedge accounting treatment. Accordingly, changes in the fair value of these hedges are recorded promptly in earnings to offset the changes in the fair value of the assets or liabilities being hedged” (10/28/07, Form 10-K, p. 58).

2. <u>Archstone</u>	Variable-rate debt	Int. rate swaps & caps	Cash flow
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Comments and quotes: An unrealized loss of \$131 million was recorded in 2007 on the interest rate swaps that were not designated as hedges for accounting purposes. Archstone noted that, “When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not, nor do we expect to sustain a material realized loss from the use of these hedging instruments” (12/31/07, Form 10-K, p. 114).

3. <u>Aspen Tech., Inc.</u>	FX receivables	FX forward contracts	Fair value
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Comments and quotes: The forward contracts were declared as mitigating their exposure to currency fluctuations on customer installments-receivable contracts denominated in foreign currencies (6/30/07, Form 10-K, p. 66).

4. <u>Brigham Exploration</u>	Oil and natural gas	Written puts	Cash flow
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Comments and quotes: Brigham Exploration de-designated all of its cash flow hedges on October 1, 2006 and indicated that all future hedges would be undesignated and subject to mark-to-market accounting. Gains and losses previously recorded in other comprehensive income are now reported in the income statement and included in revenue (12/31/07, Form 10-K, pp. 49 and 59).

5. <u>CapitalSouth Bancorp.</u>	Interest rates	Interest rate swaps	Fair value
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Comments and quotes: CapitalSouth’s interest-rate swaps do qualify but they are not designated for hedge accounting. These interest rate swaps hedge fixed-rate (fixed to variable) Federal Home Loan Bank borrowings and they would, if designated, be considered fair-value hedges (12/31/07, Form 10-K, p. 80).

6. <u>ConocoPhillips, Inc.</u>	Crude oil and natural gas	Futures, forwards, swaps & options	Fair value and cash flow
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Comments and quotes: ConocoPhillips notes that “We elected not to use hedge accounting as allowed by SFAS No. 133.” While the basis for this decision is not stated, the ConocoPhillips reference to the fair value options of SFAS No. 159 and their implications for achieving effective hedges without complying with hedge-accounting rules is no doubt a consideration (12/31/07, Form 10-K, pp. 85, 94, and 97).



**Exhibit 1 (continued)**

Company	Hedged Exposure	Derivative(s)	Accounting Hedge(s)
7. <u>Federal-Mogul Corp.</u>	FX and metals	Options and forwards	Fair value and cash flow

Comments and quotes: Federal-Mogul did hedge some forecasted transactions that were designated as cash-flow hedges. However, options and forwards used to hedge some booked transactions, and associated assets and liabilities, were not designated for hedge accounting since they were natural hedges. Forward contracts used to mitigate commodity price risk were not considered hedging instruments for accounting purposes (12/31/06, Form 10-K, p. 82).

8. <u>GeoEye, Inc.</u>	Interest rate risk	Interest rate swaps	Cash flow
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Comments and quotes: GeoEye indicates that it lacked adequate documentation at the inception of the interest rate swap to qualify the derivative for hedge accounting (12/31/07, Form 10-K, p. 40).

9. <u>H.B. Fuller, Inc.</u>	FX assets and liabilities	Forward contracts	Fair value
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Comments and quotes: H.B. Fuller works to balance local currency assets to local currency liabilities to achieve a natural hedge. Its currency derivatives hedge foreign currency assets and liabilities but are not designated as hedges for accounting purposes (12/31/07, Form 10-K, p. 55).

10. <u>Hines REIT</u>	FX and interest rate risk	Interest rate swaps	Cash flow
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Comments and quotes: Consistent with the non-designation of its derivatives, Hines REIT declares its interest rate swaps as “economic hedges against the variability of future interest rates on certain variable interest rate debt” (12/31/07, Form 10-K, pp. 53-54).

11. <u>ICT Group, Inc.</u>	FX note payable	Forward contracts	Fair value
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Comments quotes: ICT Group used forward contracts to hedge a Euro intercompany note payable from its Netherlands subsidiary. The gains and losses on the forward contract offset the losses and gains on the remeasurement of the note payable. In 2007, the losses on the hedges were \$1.0 million and the gains on the notes payable were \$1.1 million--a very effective economic or natural hedge (12/31/07, Form 10-K, F-31).

12. <u>Jabil Circuit, Inc.</u>	FX assets and liabilities	Forward contracts	Fair value
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Comments and quotes: Jabil Circuit uses “forward contracts to economically hedge transactional exposure” (8/31/07, Form 10-K, p. 64).



**Exhibit 1 (continued)**

Company	Hedged Exposure	Derivative(s)	Accounting Hedge(s)
13. <u>Lake Area Corn Processors, LLC</u>	Corn and natural gas	Forwards, options and futures	Fair value and cash flow
Comments and quotes: “Although we believe our hedge positions accomplish an economic hedge against our future purchases, they are not designated as such for hedge accounting purposes, which would match the gain or loss on our hedge positions to the specific commodity purchase being hedged. We are marking to market our hedge positions, which means as the current market price of our hedge positions changes, the gains and losses are immediately recognized in our cost of revenues” (12/31/07, Form 10-K, p. 37).			
14. <u>Netezza, Inc.</u>	FX assets and liabilities	Forward contracts	Fair value
Comments and quotes: Netezza outlines the function of its “economic hedges” as follows: “Because we enter into forward contracts only as an economic hedge, any gain or loss on the underlying foreign-denominated balance would be offset by the loss or gain on the forward contract” (1/31/08, Form 10-K, p. 43).			
15. <u>Plantronics, Inc.</u>	FX assets and liabilities	Forwards contracts	Fair value
Comments and quotes: Plantronics does designate some derivatives as cash-flow hedges that are used to hedge forecasted sales that are in foreign currencies (3/29/08, Form 10-K, pp. 49-50 and 74-75).			
16. <u>Realogy, Inc.</u>	FX assets and liabilities and forecasted earnings	Forward contracts	Fair value and cash flow
Comments and quotes: Realogy notes that, “The fluctuations in the value of these forward contracts do, however, significantly offset the impact of changes in the value of the underlying risk that they are intended to economically hedge.” Unlike its foreign-currency exposures, Realogy does elect cash-flow hedge accounting for an interest rate swap: “The derivatives are being accounted for as cash flow hedges in accordance with SFAS 133 and the change in the fair market value of the swaps of \$12 million, net of income taxes, is recorded in accumulated other comprehensive income (loss) at December 31, 2007” (12/31/07, Form 10-K, p. F-14).			
17. <u>Red Trail Energy, LLC</u>	Interest rates, corn and ethanol	Interest rate and ethanol, swaps, options & futures	Fair value and cash flow
Comments and quotes: Red Trail does not designate its interest rate swap derivatives for hedge accounting. Changes in the fair value of the interest rate swaps are included in other income and expense. Its commodity derivatives are seen as achieving an economic hedge, but “they likely will not qualify for hedge accounting which would match the gain or loss on our hedge positions to the specific commodity being hedged” (12/31/07, Form 10-K, pp. 26-27).			

**Exhibit 1 (continued)**

Company	Hedged Exposure	Derivative(s)	Accounting Hedge(s)
18. <u>Russ Berrie &amp; Co.</u>	FX related to projected inventory purchases	Forward contracts	Cash flow

Comments and quotes: In recent years, Buss Berrie has not designated its derivatives as accounting hedges. However, the Company considers the derivatives as providing an economic hedge of its inventory purchases. Prior to 2005, the derivatives were classified and accounted for as cash-flow hedges (12/31/07, Form 10-K, p. 58).

19. <u>Sara Lee Corp.</u>	FX related assets and liabilities	Forwards and options	Cash flow, fair value and net investment
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Comments and quotes: Sara Lee provides the following on its hedge accounting: “The Corporation uses either hedge accounting or mark-to-market accounting for its derivative instruments. In 2007, the Corporation adopted a policy to use mark-to-market accounting for foreign currency derivatives due to the high cost of using hedge accounting and maintaining hedge documentation” (6/30/07, annual report to shareholders, pp. 56-57).

20. <u>Serena Software, Inc.</u>	Interest rate risk	Interest rate swaps	Cash flow
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Comments and quotes: The Serena hedge involves an interest rate swap that if designated would be accounted for as a cash-flow swap. Absent hedge accounting, the gains and losses on the interest rate swap will be included in earnings as the gains and losses are recognized. This has the potential to increase the volatility of Serena’s earnings (1/31/08, Form 10-K, p. 51).

21. <u>Star Buffet, Inc.</u>	Interest rate risk	Interest rate swaps	Cash flow
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Comments quotes: With respect to its derivatives, Star Buffet provides the following: “The Company is required to obtain interest rate protection through an interest rate swap or cap arrangement with respect to not less than 50% of the term loan amount. The Company has elected to not perform the necessary procedures in order to apply hedge accounting. Therefore, changes in the fair market value of the interest rate swap will be reflected as an adjustment to interest expense within the consolidated statement of operations” (1/28/08, Form 10-K, p. F-27).

22. <u>TierOne Corp.</u>	Interest rate risk	Forward sales contracts	Fair value
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Comments and quotes: “The TierOne forward contracts are marked-to-market through earnings and are not designated as accounting hedges under SFSA No. 133. The change in the fair value of the forward sales contracts generally move in opposite directions and, accordingly, the impact of changes in these valuations on net income during the loan commitment period is generally inconsequential” (12/31/07, Form 10-K, p. 53).

**Exhibit 1 (continued)**

Company	Hedged Exposure	Derivative(s)	Accounting Hedge(s)
23. <u>TJX Companies, Inc.</u>	FX purchase commitments	Forward contracts	Fair value

Comments and quotes: “TJX enters into forward foreign currency contracts to obtain economic hedges on firm U.S. dollar and Euro merchandise purchase commitments made by its foreign subsidiaries. . . Any gain or loss on this type of contract is ultimately offset by a similar gain or loss on the underlying item being hedged.” TJX elected not to apply hedge accounting to these derivatives, although it does apply hedge accounting to some of its other foreign-currency exposures. TJX also applies hedge accounting to its interest-rate swaps, both fair value and cash flow hedge” (1/26/08, Form 10-K, p. F-13-15).

24. <u>Wells Fargo &amp; Co.</u>	Interest rate risk	Interest rate swaps, caps, floors, futures, forwards and options	Cash flow and fair value
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Comments and quotes: As a large financial institution, Wells Fargo uses derivatives for both its own risk management purposes as well as to provide customer needs for derivatives. A notable change in the accounting for some of its derivatives was prompted by the issuance of SFAS No. 159: “Upon adoption of FAS 159 on January 1, 2007, derivatives used to hedge the forecasted sales of prime residential MHFS (mortgages held for sale) originated subsequent to January 1, 2007, were accounted for as economic hedges.<sup>18</sup> We previously accounted for these derivatives as cash flow hedges under FAS 133” (12/31/07, Form 10-K, p. 101).

25. <u>WHX Holding Co.</u>	Commodities and interest rate risk	Futures and forwards	Cash flow and fair value
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Comments and quotes: WHX discloses that its goal in acquiring futures and forward contracts on precious metals is “. . . to economically hedge its precious metals inventory against price fluctuations.” WHX also reports that “The Company also economically hedges its exposure on variable interest rates at one of its subsidiaries” (12/31/07, Form 10-K, p. 101). References to economic hedges are generally associated with the non-designation of derivatives as accounting hedges, and this is the case with WHX Holding Co.

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<sup>18</sup> SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities, (Norwalk, CT: Financial Accounting Standards Board, 2007).

## Inferences from the sample

### *Some hedges can work without designation*

While no doubt obvious, it is important to note that a derivative can serve as an effective hedge (a substantial offsetting of the gains and losses associated with the derivatives and the hedged positions) without being designated for hedge accounting. As an example, the ICT Group hedged an intercompany loan with undesignated forward contracts. The results in 2007 were a gain on the intercompany loan of \$1.0 million offset by a loss on the forward contracts of \$1.1 million. This could be a motivation behind non-designation for a number of the other firms in the sample. Other comparable cases include: Applied Materials, Aspen Technology, ConocoPhillips, Federal-Mogul, H. B. Fuller, Jabil Circuit, Netezza, Realogy, and TierOne. In each of these cases, the message is twofold: (1) we did not designate the derivative as an accounting hedge, and (2) we have a hedge nonetheless since there are offsetting gains and losses.

The case of ConocoPhillips is of special interest since its non-designation position appears to be a response to the issuance of SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities.” ConocoPhillips noted the following about SFAS No. 159: “This Statement permits an entity to choose to measure financial instruments and certain other items similar to financial instruments at fair value, with all subsequent changes in fair value for the financial instrument reported in earnings. By electing the fair value option in conjunction with a derivative, an entity can achieve an accounting result similar to a fair value hedge without having to comply with complex hedge accounting rules. We will adopt this Statement effective January 1, 2008 . . .”<sup>19</sup>

### *Some hedges do not work (in the accounting sense) without designation . . . but may still work on a cumulative basis*

The notion of a hedge *working* can be defined in other ways. It is common for derivatives used as non-designated hedges, which do not result in contemporaneous offsetting gains and losses, to be referred to as economic hedges. Consider, for example, a cash-flow hedge that is not designated for hedge accounting. The gains and losses from the derivative and the hedged position may eventually offset each other (the hedge works) on a cumulative basis, even if their gains and losses are not offset on a period by period basis. The result will usually be increased earnings volatility when compared to results achieved with hedge accounting. In contrast, if the same derivative were designated for cash-flow hedge accounting, then the gains and losses on the derivative would match with the losses and gains of the hedged position (ie., the hedge works). Such a hedge would not contribute to earnings volatility.

Archstone is a case in point. Subsequent to a merger, Archstone ceased designating interest rate swaps for hedge accounting. The interest rate swaps would previously have been designated as cash flow hedges and gains and losses on these derivatives would be included in accumulated other comprehensive income. Now, without the hedge accounting designation, “the resulting gains and losses are recorded in other non-operating income or expense.” Archstone recorded an unrealized loss of \$131 million in 2007 on undesignated interest rate swaps, with no offsetting

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<sup>19</sup> ConocoPhillips, Inc., Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 85.

gain reported in its income statement that year. Archstone addresses this loss as follows: “When viewed in conjunction with the underlying and offsetting exposure that the derivatives are designed to hedge, we have not, nor do we expect to sustain a material realized loss from the use of these hedging instruments.”<sup>20</sup> While recognized in 2007, Archstone is implying that there is an offsetting economic gain that offsets the \$131 million unrealized loss, but this gain is not recognized with its current undesignated derivative.

By not designating its interest rate swaps as accounting hedges, the derivatives no longer permit a matching of the gains and losses on the derivative with offsetting losses and gains on the hedged position. However, that does not mean, necessarily, that the company has not hedged its positions or that the derivatives are not *working* as hedges. That is, the derivatives may still provide an offsetting of economic gains and losses on a cumulative basis, if not in any one year.

#### **4. Explanations for Non-designation**

This section focuses on additional insights from the disclosures of the sample firms and others that suggest the motivations behind the non-designation of derivatives for hedge accounting. A review of relevant data for fifteen firms, including ten from Exhibit 1, is summarized in Exhibit 2. The survey results indicate that the key motivations behind non-designation are: (1) the substantial cost (time and money) of documentation and ongoing monitoring of designated hedges; (2) the availability of natural hedges that can be highly effective; (3) new accounting standards that broaden the range of natural or economic hedges; and (4) qualifying hedges are not available or are too costly or documentation is untimely, inadequate, or unavailable.

##### **The cost of documentation and monitoring is onerous**

The most explicit and also the most frequently encountered reason offered for non-designation of derivatives is the burden of documentation and the ongoing monitoring of hedge effectiveness. Some illustrative firms include ConocoPhillips, Federal Home Loan Bank of New York, General Mills, Hanover Capital Mortgage Holdings, Jabil Circuit, Sara Lee, and Star Buffet.

##### **Natural hedges are effective without designation**

In discussing the hedge-accounting status of their derivatives, it is common to see references to natural hedges and their effectiveness. Examples include Aspen Technology, Federal-Mogul, Netezza, and Residential Capital, LLC and TierOne. There is little incentive to incur the costs associated with the documentation and monitoring of accounting hedges if a natural hedge can in some cases achieve the same outcome.

##### **New accounting standard broadens the applicability of natural hedges**

ConocoPhillips makes this point quite clearly in Exhibit 2 by noting the influence of SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities*. ConocoPhillips observes that the adoption of this statement makes possible fair-value accounting without complying with “complex” accounting rules. In addition, while not presented in Exhibit 2, Wells Fargo notes two cases, mortgage servicing rights and mortgages held for sale, where economic hedges have replaced accounting hedges. These economic hedges replaced fair value and cash flow hedges respectively.

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<sup>20</sup> Archstone, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 114.

**Lack of cost-effective qualifying hedges or hedge documentation**

In reviewing the factors contributing to the non-designation of accounting hedges, we noted several examples of firms that did not designate their derivatives for hedge accounting either because qualifying hedges were not available or were considered to be too costly or hedge documentation was untimely, inadequate, or unavailable. Relevant examples from Exhibit 2 include, Federal Home Loan Bank of New York, General Finance, and GeoEye.

**Exhibit 2: Explanations for the Non-designation or the Discontinuation of Hedge Accounting**

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1. Forward contracts provide a natural hedge of foreign-currency exposure to installments receivable contracts (Aspen Technology, Inc., 6/30/07, Form 10-K).
2. The election of the fair-value option (SFAS No. 159) permits the firm to “. . . achieve an accounting result similar to a fair value hedge without having to comply with complex hedge accounting rules” (ConocoPhillips, 12/31/07, Form 10-K, p. 85).
3. Qualifying hedges were not available; it was not possible to demonstrate hedge effectiveness; and the cost of a qualifying hedge was not seen to be economical (Federal Home Loan Bank of New York, 12/31/07, Form 10-K, p. 93).
4. “Options and forwards used to hedge certain booked transactions and assets and liabilities are not designated as hedging instruments under SFAS 133 as they are natural hedges” (Federal-Mogul Corp., 12/31/06, Form 10-K, p. 82).
5. “Trading and free standing derivative contracts are not linked to specific assets and liabilities on the balance sheet or to forecasted transactions in an accounting hedge relationship and, therefore, do not qualify for hedge accounting under SFAS 133.” In addition, required documentation did not exist (General Finance Corp., 6/30/07, Form 10-K, p. 25).
6. “Application of hedge accounting . . . requires significant resources, recordkeeping, and analytical systems. As a result of the rising compliance costs and the complexity associated with the application of hedge accounting, we have elected to discontinue the use of hedge accounting for our commodity derivatives at the beginning of fiscal 2008 for all new commodity derivatives entered into after the date” (General Mills Corp., 5/27/07, p. 28 of annual report to shareholders).
7. “Although the interest rate swap agreement provides the Company with an economic hedge against interest rate risk, the Company, after reviewing the applicable derivative accounting rules, determined that it did not have adequate documentation at inception of the interest rate swap agreement to qualify for hedge accounting treatment” (GeoEye, 12/31/07, p. 32).



**Exhibit 2 (continued)**

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8. “To receive such treatment (as an accounting hedge, from a firm that does not currently designate derivatives as hedges) requires extensive management and documentation, but the *costs* associated with such processes may be justified compared to the mark to market consequences of not qualifying under SFAS 133 as occurs with our use of freestanding derivatives (e.g. interest rate caps) . . .” (Hanover Capital Mortgage Holdings, Inc., 12/31/07, Form 10-K, p. 7)
  9. “The Company has elected not to prepare and maintain the documentation required to qualify as an accounting hedge . . .” (Jabil Circuit, Inc. 8/31/07, Form 10-K, p. 64).
  10. “Because we enter into forward contracts only as an economic hedge, any gain or loss on the underlying foreign-denominated balance would be offset by the loss or gain on the forward contract” (Netezza Inc., 1/31/08, Form 10-K, p. 43).
  11. “The Company has also elected not to treat currency swaps used to convert foreign currency denominated assets and liabilities into the functional currency at a floating rate as hedges for accounting purposes. The Company has elected this treatment because the changes in the fair values of the currency swaps are substantially offset by the foreign currency revaluation gains and losses of the underlying debt” (Residential Capital LLC, 12/31/07, Form 10-K, p. 151).
  12. “In 2007, 2006 and 2005, the Company accounted for its forward exchange contracts as an economic hedge . . .” Prior to 2005 the contracts were classified as cash-flow hedges (Russ Berrie & Co., Inc., 12/31/07, Form 10-K, p. 58).
  13. “In 2007, the corporation adopted a policy of mark-to-market accounting for foreign currency derivatives due to the high cost of using hedge accounting and maintaining hedge documentation” (Sara Lee Corp., 6/30/07, Form 10-K, p. 56).
  14. “The Company is required to obtain interest rate protection through an interest rate swap or cap arrangement with respect to not less than 50% of the term loan amount. The Company has elected to not perform the necessary procedures in order to apply hedge accounting.” (Star Buffet, Inc., 1/28/08, Form 10-K, p. F-27).
  15. “To mitigate the effect of interest rate risk inherent in providing loan commitments, we hedge our commitments by entering into mandatory or best efforts delivery forward sale contracts. These forward contracts are marked-to-market through earnings and are not designated as accounting hedges under SFAS No. 133. The change in the fair value of loan commitments and the change in the fair value of forward sales contracts generally move in opposite directions and, accordingly, the impact of changes in these valuations on net income during the loan commitment period is generally inconsequential” (TierOne Corp., 12/31/07, Form 10-K, p. 53).
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**Restatement risks are reduced with non-designation**

A fifth reason that may be posited for the non-designation of derivatives as hedges for accounting purposes, though one that was not offered as such by the surveyed firms, is the increased risk of restatement that accompanies hedge accounting. The complexity (documentation and monitoring) associated with derivatives designated for hedge accounting has led to a large number of restatements. These restatements involve both the intentional and unintentional misapplication of SFAS No. 133 to derivatives designated for hedge accounting. Many of the misapplications of hedge accounting involve use of the so-called *shortcut method*, which requires little or no documentation or ongoing monitoring of accounting hedges.<sup>21</sup> This method allows a presumption of perfect hedge effectiveness if several specific criteria found in SFAS 133 are met. Failure to meet those criteria often results in a restatement.<sup>22</sup> A small set of firms with restatements related to derivatives include American International Group, Bank of America, Federal National Mortgage Association (Fannie Mae), Federal Home Loan Bank of Pittsburgh, Federal Home Loan and Mortgage Corporation (Freddie Mac), Ford Motor Credit and GE Capital.

**5. Influence of Non-designation on Earnings**

As discussed in the above section, the non-designation of derivatives for hedge accounting can still leave a firm with an economic hedge that has varying degrees of offsetting (symmetrical) gains and losses. However, these gains and losses may not be recognized in the same accounting period and this can result in increased earnings volatility. The goal of reduced earnings volatility, from the use of designated accounting hedges, is at the top of the list in surveys that have, among other things, sought management input on their hedging activities.<sup>23</sup> This goal is clear in the following statement: “The objective in managing exposure to changes in foreign currency exchange rates is to reduce volatility on earnings and cash flows associated with these changes.”<sup>24</sup>

The goal of reducing potential volatility in earnings is somewhat difficult to reconcile with the abundance of derivatives that are acquired for hedging purposes, but then not designated for hedge accounting. Moreover, volatility increases will generally be greatest with undesignated cash flow hedges since the derivative gains or losses are included in the income statement without the contemporaneous matching of offsetting losses and gains. There is a clear tradeoff in these designation decisions: the cost of increased volatility versus the initial cost and ongoing burden of maintaining hedge-accounting status for derivatives. The frequent reference to the increase in earnings volatility by firms that do not designate derivatives for hedge accounting would imply that the firms are aware of this tradeoff.

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<sup>21</sup> A recent case involving a restatement prompted by a very minor misapplication of the rules associated with the “short cut” rule is found in: S. Bryan and S. Lilien, “The Case of Interest Rate Swaps and Questions for the Pozen Committee,” *The CPA Journal*, June 2008, pp. 26-31.

<sup>22</sup> For details on the shortcut method, see SFAS No. 133, paragraphs 68-70.

<sup>23</sup> G. Bodnar, G. Hayt, and R. Marston, “The Wharton Survey of Derivatives Usage by U.S. Non-Financial Firms,” *Financial Management*, (Winter 1996), pp. 113-133.

<sup>24</sup> Hospira, Inc., Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 51.

The disclosures in Exhibit 3 document the awareness of firms to the potential increase in earnings volatility that can result from the non-designation of derivatives for hedge accounting. In each of these cases a reference is made to the potential increase in volatility associated with non-designation of derivatives. While the statement of the Federal Home Loan Bank of Pittsburgh does not use the term, volatility, it implies increased volatility from differences in the recognition of gains and losses on the derivatives versus the hedged items. Each of the other examples makes a clear reference to non-designation and volatility. The General Mills case appears to be the perfect example of a firm weighing the costs of designation (rising compliance costs and complexity) versus the costs of non-designation (increased earnings volatility) and deciding on non-designation.

### **Exhibit 3: Non-designation of Derivatives and Earnings Volatility**

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#### Allstate Life Insurance Company

“Also, fluctuations in the fair value of derivatives which have not been designated for hedge accounting may result in significant volatility in net income” (12/31/07, Form 10-K, p. 16).

#### Federal Home Loan Bank of Pittsburgh

“Economic hedges address specific risks inherent in the Bank’s balance sheet, but they do not qualify for hedge accounting. As a result, income recognition on the derivatives in economic hedges may vary considerably compared to the timing of income recognition on the underlying asset or liability” (12/31/07, Form 10-K, p. 41).

#### General Mills

“As a result of the rising compliance costs and the complexity associated with the application of hedge accounting, we have elected to discontinue the use of hedge accounting for our commodity derivatives at the beginning of fiscal 2008 for all new commodity derivatives entered into after that date. Accordingly, the changes in the values of these derivatives will be recorded in earnings currently, resulting in volatility in both net earnings and gross margin” (5/27/07, annual report to shareholders, p. 28).

#### Lake Area Corn Processors

“The immediate recognition of hedging gains and losses can cause net income to be volatile from quarter to quarter due to the timing of the change in the value of the derivative instruments relative to the cost and use of the commodity being hedged” (12/31/07, Form 10-K, p. F-10).

#### MetLife Insurance Company

“The fluctuations in fair value of derivatives which have not been designated for hedge accounting can result in significant volatility in net income” (12/31/07, Form 10-K, p. F-12 and 13).

**Exhibit 3: Non-designation of Derivatives and Earnings Volatility** (continued)

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SEI Investments Company

“Since the Company does not apply hedge accounting to these derivatives, the change in the fair value of the derivative is recognized immediately in current period earnings, while the change in the fair value of the hedged asset is recorded in other comprehensive income. The Company may continue to enter into economic hedges which may not qualify for hedge accounting to support certain business strategies. These economic hedges may cause some volatility in earnings” (12/31/07, Form 10-K, p. 54).

TXU Energy Company LLC

“Because TXU Energy Company’s generation position is not marked-to-market, management has striven to make elections under SFAS 133 with respect to economic hedges of that position that allow accounting results to be more reflective of the economic position. TXU Energy Company continually assesses these elections and under SFAS 133 could de-designate positions currently accounted for as cash flow hedges, the effect of which could be more volatility of reported earnings as the positions would be marked-to-market in net income” (12/31/06, Form 10-K, p. A-10).

Western Iowa Energy

“The immediate recognition of hedging gains and losses under our treatment of our hedge positions can cause net income to be volatile from quarter to quarter due to the timing of the change in value of the derivative instruments relative to the cost and use of the commodity being hedged.” (12/31/07, Form 10-K, p. 46)

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Beyond volatility, non-designation of derivatives can increase or decrease earnings on a period to period basis. However, cumulative income or loss reported over the life of a derivative should not differ whether or not hedge accounting is employed.

In Exhibit 4 we present six companies whose income has been adjusted to compare pretax earnings reported with derivatives not designated as accounting hedges versus what pretax earnings would be if the derivatives had been designated as hedges for accounting purposes. Each of the six companies has derivatives that were not designated for hedge accounting. The gains and losses from the derivatives of these firms, which were included in income, were disclosed in either the income statement or notes to the financial statements. The adjusted earnings represent an approximation of the pretax earnings that would have resulted if hedge accounting had been used. The results without hedge accounting are simply the reported results. Limited disclosures on the derivatives-related gains and losses included in earnings reduced our sample size.

It should be noted that in each of the six cases found in Exhibit 4, the non-designated derivatives would appear to have been cash-flow hedges if they had been designated as hedges. The gap between the two income numbers, with and without hedge accounting, will normally be greater with potential cash-flow hedges than with fair-value hedges. As illustrated earlier in this report, cash-flow hedges typically have the greatest lack of gain and loss symmetry with the hedged

item. This asymmetry for cash-flow hedges arises because, unlike fair-value hedges, typically the hedged item in a cash-flow hedge is not recognized as an asset or liability along with an offsetting gain or loss.

**Exhibit 4: Pretax Earnings With and Without Hedge Accounting** (thousands of dollars)

Company	Adjusted Pretax Earnings with Hedge Accounting Income (Loss)	As-Reported Pretax Earnings without Hedge Accounting Income (Loss)	Pretax Earnings Effects with Hedge Accounting Inc% (Dec%) <sup>a</sup>
GeoEye, Inc.			
2005	\$(26,596)	\$(24,255)	(10%)
2006	21,484	24,120	(11%)
2007	73,059	69,981	4%
Hines REIT, Inc.			
2006	(33,184)	(38,490)	14%
2007	(61,030)	(86,572)	30%
Husker AG, LLC			
2005	11,900	10,092	18%
2006	26,710	28,370	6%
2007	11,159	14,075	(21%)
Lake Area Corn Processors, LLC			
2005	10,848	10,865	(0%)
2006	34,588	46,036	(25%)
2007	16,747	18,005	(7%)
Serena Software, Inc.			
2006	(41,001)	(42,155)	3%
2007	(40,668)	(48,046)	15%
WHX Corporation			
2005	(23,845)	(28,108)	15%
2006	(12,839)	(20,832)	38%
2007	(17,045)	(18,993)	10%

<sup>a</sup>Calculated as (adjusted pretax earnings minus as-reported pretax earnings) / (as-reported pretax earnings)

As seen in Exhibit 4, the earnings or loss differences between designation and non-designation of derivatives as accounting hedges are sizable, ranging from a reduction in pretax earnings of approximately 25% to an increase in pretax earnings of 38%. The median change in pretax earnings across the years presented for the six firms is an increase of 5% - the sample firms would report 5% higher pretax income if hedge accounting had been employed.

The differences in earnings and the increase in earnings volatility from non-designation of derivatives is recognized in disclosures by some of the firms reported in Exhibit 4. For example, Husker AG, LLC notes the following: "The Company's immediate recognition of hedging gains and losses can cause net income to be volatile from quarter to quarter due to the timing of the change in value of the derivative instruments relative to the cost and use of the commodity being hedged."<sup>25</sup>

Lake Area Corn Processors makes a similar reference to the influence of non-designation on earnings volatility: "Management anticipates continued volatility in our cost of goods sold due to the timing of the changes in value of the derivative instruments relative to the cost and use of the commodity being hedged."<sup>26</sup>

It is not possible to convincingly demonstrate with the limited data presented in Exhibit 4 that volatility is greater with the non-designated earnings data versus earnings reported with hedge accounting. However, it seems quite plausible that an earnings series with hedge-related gains and losses offsetting each other (hedge accounting is applied) would be less volatile than a series with only a limited amount of offsetting of gains and losses (derivatives not designated for hedge accounting).

## 6. Summary and Prospects

This project was prompted by the observance of many cases where derivatives, effective as economic hedges, are not designated as hedges for accounting purposes. The expectation is that firms would employ hedge-accounting treatment so as to reduce earnings volatility. Based upon an analysis of derivatives-related disclosures, we find four reasons for firms not to designate derivatives as hedges for accounting purposes, (1) the substantial cost (time and money) of documentation and ongoing monitoring of designated hedges; (2) the availability of natural hedges that can be highly effective; (3) a new accounting standard that broadens the applicability of natural or economic hedges; and (4) qualifying hedges are not available or are too costly or documentation is untimely, inadequate, or unavailable. A fifth reason, though one that was not offered as such by surveyed firms, is the increased risk of restatement that accompanies hedge accounting. Given these findings, it appears that the FASB's proposed simplification of hedge-accounting guidelines is a welcome move.

Beyond the use of simplified hedge accounting, we believe that another recent Statement from the FASB, SFAS 159, *The Fair Value Option for Financial Assets and Liabilities*, will also have

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<sup>25</sup> Husker AG, LLC, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 40.

<sup>26</sup> Lake Area Corn Processors, LLC, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2007, p. 29.

a noticeable effect on how firms account for derivatives.<sup>27</sup> The capacity under SFAS 159 to carry both a derivative and the hedged financial assets or liabilities at fair value with offsetting gains and losses taken to income will make it possible to achieve the benefits of hedge accounting without any of the associated costs. There is some early evidence that this movement may already be underway. The following statement from ConocoPhillips is an example:

“This Statement (SFAS 159) permits an entity to choose to measure financial instruments and certain other items similar to financial instruments at fair value, with all subsequent changes in fair value of the financial instrument reported in earnings. By electing the fair value option in conjunction with a derivative, an entity can achieve an accounting result similar to a fair value hedge without having to comply with complex hedge accounting rules. We will adopt this Statement effective January 1, 2008, and do not expect any significant impact to our consolidated financial statements.”<sup>28</sup>

In spite of a growing embrace of such fair value accounting, there will no doubt be a continuing role for hedge accounting, especially for cash-flow hedges. With future cash flows as the hedged item, an asymmetric condition exists where a current gain or loss on the derivative must be recognized but for which there is no offsetting loss or gain to be recognized on the item being hedged. In such cases, provisions are needed for deferral of any gain or loss on the derivative. The proposed amendment to SFAS 133 contains these needed provisions.

Overall, we think that the combination of SFAS 159, *The Fair Value Option for Financial Assets and Liabilities*, which will be more relevant for fair-value hedges, together with the FASB’s proposed statement, *Accounting for Hedging Activities: An Amendment of FASB Statement No. 133*, which we think will be more relevant for cash-flow hedges, offer a welcome respite from the accounting morass known as SFAS 133. Hence, firms will be able to derive the benefits of hedge accounting with no special accounting requirements (as in the case of SFAS 159) or with simplified accounting requirements (as in the case of the proposed amendment to SFAS 133).

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<sup>27</sup> Financial Accounting Standards Board, SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities*, (Norwalk, CT: Financial Accounting Standards Board, 2007).

<sup>28</sup> ConocoPhillips, Inc., Form 10-K Annual to the Securities and Exchange Commission, December 31, 2007, p. 85.